

IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

IN RE RACKABLE SYSTEMS, INC.
SECURITIES LITIGATION

No. C 09-0222 CW

ORDER GRANTING
DEFENDANTS' MOTION
TO DISMISS

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This is a securities fraud class action brought on behalf of purchasers of Rackable Systems, Inc.'s securities between October 30, 2006 and April 4, 2007. Defendants Rackable, Thomas Barton, Madhu Ranganathan and Todd Ford are alleged to have defrauded investors by failing to disclose materially adverse conditions of the company. Defendants have filed a motion to dismiss Plaintiffs' Supplemental Second Amended Complaint (2AC). Lead Plaintiffs Gerald Dull and Vincent Fusco oppose the motion. The motion was heard on July 15, 2010. Having considered all of the parties' papers and oral argument on the motion, the Court grants Defendants' motion.

BACKGROUND¹

Defendant Rackable designs, manufactures and implements computer servers and storage systems. Its customers include over

¹All facts are taken from Lead Plaintiffs' 2AC and from judicially noticeable documents and are assumed to be true for purposes of this motion.

1 300 companies worldwide in the internet, semiconductor design,
2 enterprise software, entertainment, financial services, oil and gas
3 exploration and biotechnology industries and the federal
4 government. Rackable was founded in 1999 and conducted its initial
5 public offering in June, 2005. In May, 2009, Rackable acquired
6 Silicon Graphics, Inc. The combined entity now carries the name of
7 the newly acquired company. Defendant Barton is the former Chief
8 Executive Officer; Defendant Ranganathan is the former Chief
9 Financial Officer and Principal Finance and Accounting Officer; and
10 Defendant Ford is the former Executive President of Operations.

11 Lead Plaintiffs Gerald Dull and Vincent Fusco purport to
12 represent a class of persons and entities that bought common stock
13 of Rackable between October 30, 2006 and April 4, 2007 (Class
14 Period).

15 In Rackable's first annual report as a public company, it
16 noted several factors that could affect its ability to stay
17 profitable. It stated that it relies on a relatively small number
18 of customers for a significant portion of its revenue. In 2005,
19 Microsoft, Yahoo! and Amazon accounted for fourteen percent,
20 twenty-two percent and twenty-four percent of Rackable's revenue
21 respectively.

22 Rackable maintains a build-to-order business model, which, as
23 it disclosed to its investors, requires it to purchase components
24 and materials for its products in spot markets. Thus, it noted
25 that its costs are sensitive to market price volatility. Rackable
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1 also specifically disclosed that historically prices for DRAM² have
2 been volatile and it was becoming an increasingly larger percentage
3 of Rackable's bill of materials.

4 On February 22, 2006, Rackable disclosed that in December,
5 2005 it had identified "potential state sales and use tax
6 liabilities relating to certain of our product sales to customers
7 outside of California," which it estimated to be \$1.2 million.
8 Request for Judicial Notice (RJN), Exh. 2 at 27. Rackable stated
9 that, if it could not recover the sales tax from its customers, it
10 would have to record an additional charge to its operating results
11 and pay the sales tax out of its own funds. Id.

12 On October 30, 2006, Rackable announced that its total revenue
13 for the first three quarters was \$254.5 million, up ninety-two
14 percent from \$131.9 million for the same period in 2005.
15 Rackable's non-GAAP³ gross margin of 22.6 percent for the third
16 quarter was within its projection of twenty-two to twenty-four
17 percent. Rackable projected that its 2006 fourth quarter revenue
18 would be between \$100 and \$110 million, non-GAAP gross margins
19

20 ²DRAM is a type of computer memory used in Rackable's
21 products.

22 ³SEC Regulation G regulates the use of financial measures that
23 are not prepared in accordance with generally accepted accounting
24 principles (GAAP). These are commonly referred to as "non-GAAP
25 financial measures." The non-GAAP gross margin and net income
26 excludes stock-based compensation expenses. Rackable excludes from
27 its non-GAAP gross margin and non-GAAP net income "certain
28 nonrecurring items to facilitate its review of the comparability of
the company's core operating performance on a period to period
basis because such times are not related to the company's ongoing
core operating performance as viewed by management." RJN, Exh. 10.
Rackable notes that "these non-GAAP financial measures have
limitations as an analytical tool, and are not intended to be an
alternative to financial measures prepared in accordance with
GAAP." Id.

1 would be between twenty-three and twenty-four percent, and non-GAAP
2 net income would be between \$0.25 and \$0.75 per share.

3 Rackable missed these projections. On January 16, 2007,
4 Rackable announced that its revenue for the fourth quarter would be
5 between \$105.5 and \$106.8 million, non-GAAP gross margins would be
6 between 19.2 and 19.7 percent and non-GAAP net income would be
7 between \$0.17 and \$0.18 per share. It stated that the "primary
8 factors" for the miscalculation were (1) DRAM pricing higher than
9 anticipated, (2) intense competitive conditions that caused the
10 company to price contracts more aggressively in order to maintain
11 and expand its customer base and (3) lower than expected sales of a
12 new product, "RapidScale." RJN, Exh. 10. The next day, Rackable's
13 stock price fell from \$32.42 per share to \$19.98 per share.

14 On February 1, 2007, Rackable announced its final financial
15 results for the fourth quarter and full year of 2006. The final
16 figures announced for the fourth quarter of 2006 were total revenue
17 of \$106.9 million, non-GAAP gross margins of 19.8% and non-GAAP net
18 income of \$0.19 per share. Defendant Barton explained that this
19 shortfall was due to (1) unexpectedly high prices of DRAM,
20 (2) intentional business decisions to maintain market share and win
21 business in the face of aggressive competition, (3) lower than
22 anticipated sales of RapidScale products and (4) revenue production
23 that was "backend loaded" for the quarter. Id., Exh. 24. The next
24 day, Rackable's stock fell to \$16.60 per share.

25 On February 28, 2007, Rackable disclosed that it had increased
26 its reserve for potential sales and use tax liability to \$6.5
27 million. On April 4, 2007, Rackable announced that it expected
28 revenue for the first quarter to fall within previous projections

1 of \$70 to \$75 million, but that its GAAP and non-GAAP gross margins
2 would be thirty percent lower than expected. Barton stated,
3 "Intense competitive conditions for business at our largest
4 customers continued throughout the first quarter of 2007, which
5 negatively impacted our gross margin and bottom line." After this
6 announcement, Rackable's stock price fell to \$14.25 per share.

7 On April 26, 2007, Rackable released its final results for the
8 first quarter of 2007. Its total revenue was within the projected
9 range, but it experienced a GAAP net loss of \$10.2 million.

10 Defendant Barton announced that, to address the increased
11 competition, "we have also come to the conclusion that we need to
12 accelerate a shift in our overall business model, specifically to
13 increase the level of standardization in our product line, and to
14 move from a pure build-to-order model to a configure-to-order
15 model." Id., Ex. 31 at 3. The next day, Rackable's stock price
16 fell to \$11.27 per share.

17 On January 16, 2009, Plaintiffs filed this shareholder class
18 action, alleging that Defendants engaged in a fraudulent scheme to
19 inflate Rackable's value by misrepresenting its true financial
20 condition. Specifically, Plaintiffs assert that Rackable's 2006
21 fourth quarter projections were false when made and that Rackable's
22 stock price fell from January 16, 2007 to April 26, 2007 as a
23 result of the "truth" regarding Defendants' alleged
24 misrepresentations reaching the market.

25 On June 15, 2009, Plaintiffs filed the First Amended Complaint
26 (1AC), which Defendants moved to dismiss on August 13, 2009. On
27 January 13, 2010, the Court granted Defendants' motion and granted
28 Plaintiffs leave to file an amended complaint. Plaintiffs filed

1 the 2AC on February 3, 2010. On April 5, 2010, the Court granted
2 Plaintiffs leave to file a Supplemental 2AC, which changed only the
3 names of the lead Plaintiffs in the action.⁴ While it is slightly
4 longer and contains allegations from more confidential witnesses
5 than the 1AC, the 2AC suffers from the same faults as the earlier
6 complaint.

7 LEGAL STANDARD

8 A complaint must contain a "short and plain statement of the
9 claim showing that the pleader is entitled to relief." Fed. R.
10 Civ. P. 8(a). When considering a motion to dismiss under Rule
11 12(b)(6) for failure to state a claim, dismissal is appropriate
12 only when the complaint does not give the defendant fair notice of
13 a legally cognizable claim and the grounds on which it rests.
14 Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 555 (2007). In
15 considering whether the complaint is sufficient to state a claim,
16 the court will take all material allegations as true and construe
17 them in the light most favorable to the plaintiff. NL Indus., Inc.
18 v. Kaplan, 792 F.2d 896, 898 (9th Cir. 1986). However, this
19 principle is inapplicable to legal conclusions; "threadbare
20 recitals of the elements of a cause of action, supported by mere
21 conclusory statements," are not taken as true. Ashcroft v. Iqbal,
22 ___ U.S. ___, 129 S. Ct. 1937, 1949-50 (2009) (citing Twombly, 550
23 U.S. at 555).

24 REQUESTS FOR JUDICIAL NOTICE

25 Federal Rule of Evidence 201 allows a court to take judicial
26 notice of a fact "not subject to reasonable dispute in that it is

27 ⁴For convenience, the Court refers to the "Supplemental 2AC"
28 as the "2AC."

1 . . . capable of accurate and ready determination by resort to
2 sources whose accuracy cannot reasonably be questioned." Even
3 where judicial notice is not appropriate, courts may also properly
4 consider documents "whose contents are alleged in a complaint and
5 whose authenticity no party questions, but which are not physically
6 attached to the [plaintiff's] pleadings." Branch v. Tunnell, 14
7 F.3d 449, 454 (9th Cir. 1994).

8 The Court grants Defendants' request for judicial notice of
9 Exhibits 1 through 23 of the request because SEC filings may be
10 judicially noticed. See Dreiling v. American Exp. Co., 458 F.3d
11 942, 946 (9th Cir. 2006). The Court also grants Defendants'
12 requests as to Exhibits 24 through 53 -- conference call
13 statements, Rackable's press releases, analyst reports and news
14 articles -- but not for the truth of their contents.

15 I. Section 10(b) of the Exchange Act and Rule 10b-5

16 Section 10(b) of the Exchange Act makes it unlawful for any
17 person to "use or employ, in connection with the purchase or sale
18 of any security . . . any manipulative or deceptive device or
19 contrivance in contravention of such rules and regulations as the
20 [SEC] may prescribe." 15 U.S.C. § 78j(b); see also 17 C.F.R.
21 § 240.10b-5 (Rule 10b-5). To state a claim under § 10(b), a
22 plaintiff must allege: "(1) a misrepresentation or omission of
23 material fact, (2) scienter, (3) a connection with the purchase or
24 sale of a security, (4) transaction and loss causation, and
25 (5) economic loss." In re Gilead Sciences Securities Litig., 536
26 F.3d 1049, 1055 (9th Cir. 2008).

27 Some forms of recklessness are sufficient to satisfy the
28 element of scienter in a § 10(b) action. See Nelson v. Serwold,

1 576 F.2d 1332, 1337 (9th Cir. 1978). Within the context of § 10(b)
2 claims, the Ninth Circuit defines "recklessness" as

3 a highly unreasonable omission [or misrepresentation],
4 involving not merely simple, or even inexcusable
5 negligence, but an extreme departure from the standards
6 of ordinary care, and which presents a danger of
misleading buyers or sellers that is either known to the
defendant or is so obvious that the actor must have been
aware of it.

7 Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir.
8 1990) (en banc) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553
9 F.2d 1033, 1045 (7th Cir. 1977)). As explained by the Ninth
10 Circuit in In re Silicon Graphics Inc. Securities Litig., 183 F.3d
11 970 (9th Cir. 1999), recklessness, as defined by Hollinger, is a
12 form of intentional conduct, not merely an extreme form of
13 negligence. See Silicon Graphics, 183 F.3d at 976-77. Thus,
14 although § 10(b) claims can be based on reckless conduct, the
15 recklessness must "reflect[] some degree of intentional or
16 conscious misconduct." See id. at 977. The Silicon Graphics court
17 refers to this subspecies of recklessness as "deliberate
18 recklessness." See id. at 977.

19 Plaintiffs must plead any allegations of fraud with
20 particularity, pursuant to Rule 9(b) of the Federal Rules of Civil
21 Procedure. In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1543
22 (9th Cir. 1994) (en banc). Pursuant to the requirements of the
23 Private Securities Litigation Reform Act (PSLRA), the complaint
24 must "specify each statement alleged to have been misleading, the
25 reason or reasons why the statement is misleading, and, if an
26 allegation regarding the statement or omission is made on
27 information and belief, the complaint shall state with
28 particularity all facts on which that belief is formed." 15 U.S.C.

1 § 78u-4(b)(1).

2 Further, pursuant to the requirements of the PSLRA, a
3 complaint must "state with particularity facts giving rise to a
4 strong inference that the defendant acted with the required state
5 of mind." 15 U.S.C. § 78u-4(b)(2). The PSLRA thus requires that a
6 plaintiff plead with particularity "facts giving rise to a strong
7 inference that the defendant acted with," at a minimum, deliberate
8 recklessness. See 15 U.S.C. § 78u-4(b)(2); Silicon Graphics, 183
9 F.3d at 977. Facts that establish a motive and opportunity, or
10 circumstantial evidence of "simple recklessness," are not
11 sufficient to create a strong inference of deliberate recklessness.
12 See Silicon Graphics, 183 F.3d at 979. To satisfy the heightened
13 pleading requirement of the PSLRA for scienter, plaintiffs "must
14 state specific facts indicating no less than a degree of
15 recklessness that strongly suggests actual intent." Id.

16 A. Misrepresentation or Omission of a Material Fact

17 To state a claim pursuant to § 10(b) of the Exchange Act,
18 Plaintiffs must allege, among other things, a misrepresentation or
19 omission of a material fact. In the 2AC, just as in the 1AC,
20 Plaintiffs assert that Defendants made false and misleading
21 statements about Rackable's (1) gross margin and earnings per share
22 (EPS) projections for the fourth quarter of 2006 (4Q06),
23 (2) collection of sales and use taxes from its customers,
24 (3) inventory procurement system, (4) ERP system,⁵ (5) relationship
25 with its top three customers and (6) projected sales of RapidScale
26 products. The Court addresses each of these allegations in turn.

27
28 ⁵ERP is an electronic resource planning system designed by
Oracle better to track Rackable's costs and revenues.

1 1. Gross Margin and EPS Projections

2 Plaintiffs' 2AC continues to allege that Rackable's gross
3 margin and EPS projections for 4Q06 were false when made because
4 Defendants knew that Rackable's profitability during the quarter
5 would be negatively affected by the billing of sales and use tax to
6 its customers, increased inventory costs and the discounting of a
7 contract with one of its customers. However, Plaintiffs fail to
8 allege contemporaneous facts that show that Defendants did not have
9 a reasonable basis for these projections when they were made.
10 Plaintiffs assert that, because risks materialized later in the
11 quarter, risks which caused Rackable to fall short of its
12 projections, Defendants must have known that the projections were
13 false at the time that they made them. As with the 1AC, Plaintiffs
14 cannot simply rely on a "fraud by hindsight" theory to demonstrate
15 falsity. In re Vantive Corp. Sec. Litig., 283 F.3d 1079, 1084-85
16 (9th Cir. 2002) ("The purpose of [the PSLRA's] heightened pleading
17 requirement was generally to eliminate abusive securities
18 litigation and particularly to put an end to the practice of
19 pleading 'fraud by hindsight.'"); In re Sytex Corp. Sec. Litig., 95
20 F.3d 922, 934 (9th Cir. 1996) ("Because Defendants' predictions
21 proved to be wrong in hindsight does not render the statements
22 untrue when made.").

23 The new facts Plaintiffs allege in their 2AC do not remedy
24 these problems. The 2AC alleges that Rackable hired an outside
25 auditor to investigate the costs associated with manufacturing
26 products. However, Plaintiffs do not describe the results of the
27 auditor's investigation and there is no basis to infer that the
28 results of the investigation somehow made any of Defendants' 4Q06

1 projections false or misleading. See Silicon Graphics, 183 F.3d at
2 988 (allowing plaintiffs "to go forward with a case based on
3 general allegations of 'negative internal reports' would expose all
4 those companies to securities litigation whenever their stock
5 prices dropped.").

6 Plaintiffs also add new allegations that 4Q06 was a difficult
7 quarter for Rackable. Plaintiffs allege that Rackable's strategy
8 was to offset lower margins on sales to its largest customers "by
9 achieving higher margin sales with the RapidScale product line and
10 by establishing a stable, worldwide sales force to expand the
11 customer base." 2AC ¶ 64(a). The shortcomings in the execution of
12 this strategy do not mean that, at the time the strategy was made,
13 Rackable had no reason to believe that it could be effective. In
14 fact, this strategy had been effective for Rackable in the past.
15 In a business as large and complex as Rackable, "problems and
16 difficulties are the daily work of business people. That they
17 exist does not make a lie out of any alleged false statement."
18 Ronconi v. Larkin, 253 F.3d 423, 434 (9th Cir. 2001).

19 In sum, Plaintiffs have not plead specific facts from which a
20 reasonable inference can be made that Defendants knew their
21 projections about their gross margin and EPS were false at the time
22 that they made them.

23 2. Sales and Use Tax

24 Plaintiffs claim that Rackable's financial statements and
25 projections were false and misleading because Defendants should
26 have disclosed, in advance, the impact that charging sales tax
27 might have on Rackable's competitive position. Specifically,
28 Plaintiffs argue that Defendants should have disclosed in the June,

1 2005 Initial Public Offering that Rackable was not charging its
2 customers sales tax. Plaintiffs argue that when Rackable decided
3 to charge sales tax it was no longer able to price its products
4 competitively and that failing to disclose this information misled
5 investors. However, Rackable notified the market of its potential
6 sales and use tax liability in February, 2006, which is months
7 before the Class Period. At that time, Rackable disclosed that it
8 had recorded a charge for amounts owed from its customers, but that
9 "if we are not able to recover these sales taxes from these
10 customers, we will record an additional charge to our operating
11 results and need to pay these taxes out of our funds." RJN, Exh. 2
12 at 27. Throughout the class period, Rackable continued to increase
13 its reserve for unpaid taxes and notify shareholders of the issue.
14 See e.g., RJN, Exh. 8 at 18; Id., Exh. 12 at 20.

15 Plaintiffs also claim that Rackable's financial statements and
16 projections were false and misleading because Defendants
17 understated its sales and use tax liability. However, Rackable's
18 sales and use tax liability could not have had any direct impact on
19 its gross margin because Rackable's unpaid sales and use tax was
20 recorded as a "general and administrative" expense or "accrued
21 expense," not as a "cost of revenue." See RJN, Exh. 12 at 20
22 (charging accrued sales and use tax as general and administrative
23 expense), 31 (defining cost of revenue), 40 (calculating gross
24 margin as revenue less cost of revenue), 75 (including accrued
25 sales and use tax as component of accrued expense). Plaintiffs
26 assert that Rackable should not have accounted for unpaid sales tax
27 in this manner and that it should have had a separate "reserve for
28 non-payment" of sales tax. However, the 2AC does not allege that

1 such accounting treatment was required under GAAP or that Rackable
2 had enough information about the amounts it could not collect to
3 create such a reserve. Moreover, creating such a reserve would not
4 have communicated any additional information to investors because
5 Rackable had already disclosed that it would have to pay all unpaid
6 sales tax that it was unable to collect from its customers.

7 In sum, Plaintiffs have not adequately alleged with
8 particularity that any statements regarding Rackable's sales and
9 use tax liability were false or misleading.

10 3. Inventory Procurement System

11 The 2AC alleges that Rackable's financial statements and
12 projections were false and misleading because it failed to account
13 properly for excess and obsolete supplies that it used in making
14 its computer servers and storage systems. Specifically, Plaintiffs
15 allege that, by December 31, 2006, Defendants knew, but failed to
16 disclose, that Rackable's customers would not purchase its products
17 above their listed prices, and, therefore, Rackable should have
18 written off these supplies as a loss earlier than it did. However,
19 Rackable regularly disclosed that its build-to-order business model
20 carried substantial costs and risks. See e.g., RJN, Exh. 5 at 28,
21 Exh. 2 at 21. Plaintiffs have not alleged that Defendants knew in
22 advance that it would purchase more supplies than it needed; nor
23 are there any allegations that Rackable failed to write off its
24 excess supplies in an appropriate manner.

25 Further, when Rackable wrote down its inventory in the second
26 quarter of 2007, it disclosed the following reasons for its
27 decision: (1) a "significant reduction in our forecasted usage for
28 the next twelve months," (2) a "customer driven, technology

1 platform shift from AMD to Intel" and (3) "lower than expected
2 revenue from 2007 and a shift in customer preference to next
3 generation power supplies created an excess in power supplies on
4 hand." RJN, Exh. 19 at 20-21. Plaintiffs have not alleged with
5 particularity any facts to refute these explanations.

6 4. ERP System

7 Plaintiffs assert that Defendants concealed that Rackable's
8 ERP System failed adequately to track Rackable's inventory and
9 other costs to support its financial statements and projections.
10 However, Plaintiffs continue to fail to allege that Defendants were
11 aware of any alleged deficiencies in the ERP System when financial
12 statements and projections were made. Plaintiffs rely on
13 Rackable's internal recommendations to improve the system, but
14 these recommendations were made well after the Class Period and do
15 not prove that Defendants misrepresented the ERP System's
16 effectiveness. The only allegations that allude to contemporaneous
17 information relate to difficulties in implementing the system.
18 However, problems in implementing the system and inaccurate
19 statements projecting when the implementation would be completed do
20 not suggest that Rackable's financial projections were fraudulent.

21 5. Relationship with Top Customers

22 In Plaintiffs' 2AC, they continue to allege that Defendants
23 Barton and Ranganathan made false and misleading statements during
24 an October 30, 2006 earnings conference call when they stated that
25 Rackable's relationship with its top three customers remained
26 "solid." Complaint ¶ 86. To support their allegation, Plaintiffs
27 rely on the fact that four months after this statement was made,
28 Rackable provided a large discount to one of its top three

1 customers in order to prevent that customer from going to a
2 competitor. Giving a customer a discount does not mean that a
3 relationship with that customer is not "solid." Moreover,
4 Plaintiffs have failed to allege how this statement was false or
5 misleading at the time that it was made. Defendants' general
6 statements of optimism are not actionable under securities laws.
7 See Glen Holly Entertainment, Inc. v. Tektronix, Inc., 352 F.3d
8 367, 379 (9th Cir. 2003); Wenger v. Lumisys, Inc., 2 F. Supp. 2d
9 1231, 1245 (N.D. Cal. 1998) ("No matter how untrue a statement may
10 be, it is not actionable if it is not the type of statement that
11 would significantly alter the total mix of information available to
12 investors.") (quotation marks and citation omitted); In re
13 VeriFone Sec. Litig., 784 F. Supp. 1471, 1481 (N.D. Cal. 1992),
14 aff'd, 11 F.3d 865 (9th Cir. 1993) ("Professional investors, and
15 most amateur investors as well, know how to devalue the optimism of
16 corporate executives, who have a personal stake in the future
17 success of the Company.").

18 6. RapidScale Products

19 Plaintiffs allege that Defendants misled investors by
20 projecting \$20 million in sales of RapidScale products in 2007.
21 Midway through 2007, newly appointed CEO Mark Barrenechea stated
22 that "the execution wasn't there to support [the \$20 million]
23 projection." However, failing to meet a projection does not make
24 the projection a misrepresentation. As with many of the
25 allegations above, Plaintiffs fail to allege contemporaneous facts
26 inconsistent with the projection.

27 B. Forward-Looking Statements

28 Defendants' projections and forward-looking statements are

1 inactionable under the PSLRA's safe harbor and the "bespeaks
2 caution" doctrine. Forward-looking statements are not actionable
3 if they are accompanied by meaningful cautionary language.
4 Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v.
5 Clorox Co., 353 F.3d 1125, 1133-34 (9th Cir. 2004). Defendants'
6 projections about the fourth quarter of 2006 and the 2007 fiscal
7 year easily meet the definition of a forward-looking statement
8 because they are statements containing a "projection of revenues,
9 income (including income loss), earnings (including earnings loss)
10 per share, capital expenditures, dividends, capital structure, or
11 other financial items." 15 U.S.C. § 78u-5(i)(1)(A). And, these
12 forward-looking statements were consistently accompanied by such
13 cautionary language. See RJN Exs. 5, 7, 11-13, 28-29.

14 Even if unaccompanied by cautionary language, forward-looking
15 statements cannot support liability unless they are made with
16 actual knowledge of their falsity. See 15 U.S.C.
17 § 78u-5(c)(1)(A)(i). As described below, Plaintiffs have not plead
18 with particularity Defendants' actual knowledge of falsity.

19 C. Requisite Mental State

20 A complaint must "state with particularity facts giving rise
21 to a strong inference that the defendant acted with the required
22 state of mind." 15 U.S.C. § 78u-4(b)(2). When evaluating the
23 strength of an inference, "the court's job is not to scrutinize
24 each allegation in isolation but to assess all the allegations
25 holistically." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551
26 U.S. 308, 325 (2007). "The inference of scienter must be more than
27 merely 'reasonable' or 'permissible' -- it must be cogent and
28 compelling, thus strong in light of other explanations." Id. at

1 324. A complaint will survive "only if a reasonable person would
2 deem the inference of scienter cogent and at least as compelling as
3 any opposing inference one could draw from the facts alleged." Id.
4 However, "the inference that the defendant acted with scienter need
5 not be irrefutable, i.e., of the 'smoking-gun' genre, or even the
6 'most plausible of competing inferences.'" Id.

7 Plaintiffs allege that there is a strong inference that
8 Defendants acted with scienter because of Defendants'

9 (1) interactions with CWs, (2) motive to commit fraud,
10 (3) admissions, (4) involvement in Rackable's core operations,
11 (5) documents filed with the SEC and (6) violations of GAAP.

12 1. Confidential Witnesses

13 The twenty-two confidential witnesses described in the
14 complaint fail to support an inference of scienter. Seven of the
15 confidential witnesses -- CW1, CW3, CW5, CW6, CW 8, CW 17 and CW 21
16 -- were not employed at Rackable during the Class Period, which
17 makes it unlikely that they had personal knowledge of Defendants'
18 relevant state of mind. See Zucco Partners v. Digimarc, 552 F.3d
19 981, 996 (9th Cir. 2009); Brodsky v. Yahoo!, Inc., 2009 WL 176002,
20 at *10 (N.D. Cal.). The remaining CWs who were employed by
21 Rackable during the Class Period are not alleged "to have had any
22 interaction or communication with any of the defendants, or to have
23 provided any defendant with information, or to have heard or read
24 any statement by any defendant, that contradicted or even cast
25 doubt on a public statement made during the class period."
26 McCasland v. FormFactor, Inc., 2008 WL 2951275, at *8 (N.D. Cal.).

27 Further, the CWs only provide vague assertions about the
28 financial conditions at Rackable. The CWs allege general knowledge

1 about inventory shortages and excesses, minimum purchase
2 requirements, ERP implementation problems and sales tax issues.
3 However, the CWs do not provide the level of particularity from
4 which to infer that Rackable knew that it would miss its gross
5 margin and EPS projections or that any statement by Defendants was
6 made with fraudulent intent. The CWs do not "allege
7 contemporaneous facts in sufficient detail and in a manner that
8 would create a strong inference that the alleged adverse facts were
9 known at the time of the challenged statements." In re Vantive
10 Corp. Sec. Litig., 283 F.3d 1079, 1085 (9th Cir. 2002).

11 2. Motive

12 Plaintiffs allege that Defendants were highly motivated to
13 conceal adverse facts about Rackable from the public.
14 Specifically, Plaintiffs allege that Defendants' insider sales of
15 stocks since the IPO support an inference of scienter. However,
16 only one Defendant, Ford, is alleged to have sold any stock during
17 the Class Period; and he sold more stock before the Class Period
18 than during the Class Period. In re Apple Computer Sec. Litig.,
19 886 F.2d 1109, 1117 (9th Cir. 1989) ("Large sales of stock before
20 the class period are inconsistent with plaintiffs' theory that
21 defendants attempted to drive up the price of Apple stock during
22 the class period.") (emphasis in original). Insider stock sales
23 become suspicious "only when the level of trading is dramatically
24 out of line with prior trading practices at times calculated to
25 maximize the personal benefit from undisclosed inside information."
26 Vantive, 283 F.3d at 1092. Ford sold 55,000 shares between October
27 30, 2006 and January 16, 2007 at \$33.85 to \$34.50 per share. This
28 is when Plaintiffs allege that the fraud began to be revealed to

1 the market. However, Defendant Ford sold almost as many shares,
2 52,000, from January 17, 2007 through the end of the Class Period,
3 at prices ranging from \$18.20 to \$13.00. These sales do not
4 reflect an intention to maximize profits from an artificially
5 inflated stock price. Further, the fact that Defendants Barton and
6 Ranganathan did not sell any stock during the Class Period further
7 undermines any inference of scienter from stock sales.

8 Plaintiffs also argue that Defendants' compensation packages
9 support an inference of scienter because they were "extraordinary
10 by any measure." Opposition at 14. Plaintiffs allege that
11 Defendants were motivated to commit fraud to obtain additional
12 compensation from Rackable and to sell their company stock at
13 inflated prices. Compared to the industry norms, the type or
14 amount of compensation paid to Defendants is not remarkable.

15 3. Admissions

16 A "later statement may suggest that a defendant had a
17 contemporaneous knowledge of the falsity of his statement, if the
18 later statement directly contradicts or is inconsistent with the
19 earlier statement." In re Read-Rite Corp. Sec. Litig., 335 F.3d
20 843, 846 (9th Cir. 2003). However, "[i]t is clearly insufficient
21 for plaintiffs to say that a later, sobering revelation makes an
22 earlier, cheerier statement a falsehood." Yourish v. Cal.
23 Amplifier, 191 F.3d 983, 997 (9th Cir. 1999). Plaintiffs rely on
24 the following statement, which was made by Ford in a February, 1,
25 2007 conference call in response to \$300,000 in higher than
26 anticipated overhead costs: "Admittedly, we should have realized
27 the impact of these issues earlier in the quarter." 2AC ¶ 125.
28 Plaintiffs also rely on the statement that, with respect to the \$20

1 million forecast for RapidScale, "the execution wasn't there to
2 support the projection." Id. at ¶ 176. These statements do not
3 show that Defendants possessed contemporaneous knowledge of any
4 facts contradicting an earlier statement. Specifically, they do
5 not show that Defendants knew that their revenue projections were
6 false and misleading when made. These statements are merely
7 acknowledgments that the company could have been run better in the
8 past.

9 4. Defendants' Involvement in Rackable's core
10 Operations

11 Plaintiffs argue that Rackable's small size supports a strong
12 inference of scienter. Allegations regarding management's role in
13 a company "may be used in any form along with other allegations
14 that, when read together, raise an inference that is 'cogent and
15 compelling, thus strong in light of other explanations.'" South
16 Ferry LP v. Killinger, 542 F.3d 776, 785 (9th Cir. 2008) (quoting
17 Tellabs, 551 U.S. at 324); Zucco, 522 F.3d at 1001, 1007. These
18 allegations may conceivably satisfy the PSLRA standard "without
19 accompanying particularized allegations, in rare circumstances
20 where the nature of the relevant fact is of such prominence that it
21 would be 'absurd' to suggest that management was without knowledge
22 of the matter." South Ferry, 542 F.3d at 786.

23 The Ninth Circuit described such a "rare circumstance" in
24 Berson v. Applied Signal Technology, Inc., 527 F.3d 982 (9th Cir.
25 2008). There, the plaintiffs alleged facts which contradicted the
26 defendants' statements about the company's revenue stream. The
27 company had received four stop-work orders that had a "devastating
28 effect" on the company's revenue. Id. at 987. The court drew an

1 inference of scienter from the defendants' involvement in the
2 company's core operations because these facts were of such
3 prominence "that it would be 'absurd to suggest' that top
4 management was unaware of them." Id. at 989.

5 Here, Plaintiffs fail to plead any similar facts of such
6 magnitude that it would be absurd to suggest that Defendants were
7 unaware of them. Plaintiffs merely suggest that the facts that
8 Rackable had 174 and 286 employees as of year-end 2005 and 2006,
9 respectively, and only ten executive officers supports an inference
10 of scienter. Even combined with the other scienter allegations,
11 Plaintiffs' allegations about Rackable's size are not specific
12 enough to allege scienter. 2AC ¶¶ 40, 232-33.

13 5. Filing of False Documents with the SEC

14 Plaintiffs also allege that Defendants' signing of SEC
15 certificates creates a strong inference of scienter. Under the
16 Sarbanes-Oxley Act of 2002, Defendant Barton as CEO and Defendant
17 Ranganathan as CFO were required to certify certain aspects of
18 Rackable's 10-Q and 10-K Forms. See 15 U.S.C. § 7241. These
19 Defendants certified that, based on their knowledge, each quarterly
20 and annual report to the SEC and investors did not contain untrue
21 statements of a material fact or omit to state a material fact.
22 CAC ¶ 225. Plaintiffs allege that this certificate is evidence
23 that Defendants Barton and Ranganathan knew or recklessly
24 disregarded information about the adequacy of the internal controls
25 over Rackable's financial reporting. This argument is not
26 persuasive. Without any supporting allegations that Defendants
27 made false accounting entries or inflated revenues, Defendants'
28 signatures on the SEC certificates do not create a strong inference

1 of scienter. See In re Intelligroup Securities Litig., 527 F.
2 Supp. 2d 262, 289-90 (D. N.J. 2007) ("[W]hile the issue of what
3 impact a Sarbanes-Oxley certification has on a 10b-5 claim is a
4 relatively novel question, the above-discussed holdings indicate
5 that--as with allegations that defendants violated GAAP--
6 allegations based on defendants' erroneous SOX certification cannot
7 establish the requisite strong inference of scienter unless the
8 complaint asserts facts indicating that, at the time of
9 certification, defendants knew or consciously avoided any
10 meaningful exposure to the information that was rendering their SOX
11 certification erroneous.").

12 6. GAAP Violations

13 Plaintiffs claim that Defendants' "deceptive inventory and
14 sales tax reporting violated GAAP." Opposition at 20. See In re
15 Daou Sys., Inc. Sec. Litig., 411 F.3d 1006, 1016 (9th Cir. 2005)
16 ("Violations of GAAP standards can also provide evidence of
17 scienter."); In re McKesson HBOC, Inc. Sec. Litig., 126 F. Supp. 2d
18 1248, 1273 (N.D. Cal. 2000) ("when significant GAAP violations are
19 described with particularity in the complaint, they may provide
20 powerful indirect evidence of scienter. After all, books do not
21 cook themselves."). Plaintiffs rely on the allegation that
22 Rackable wrote off a substantial amount of obsolete inventory three
23 months after the Class Period. It is not clear how this write-off,
24 which occurred after the Class Period, is evidence of Defendants'
25 knowledge during the Class Period. Further, because Plaintiffs
26 have not alleged with particularity that Rackable's financial
27 statements regarding its reserves for sales and use tax liability
28 were false, Plaintiffs' allegations regarding Defendants' GAAP

1 violations fail.

2 In sum, Plaintiffs' allegations do not create a strong
3 inference that Defendants acted with scienter. Even when viewed
4 cumulatively, these allegations do not establish a strong inference
5 that Defendants acted with deliberate recklessness. Therefore,
6 Plaintiffs have not adequately alleged that Defendants violated
7 § 10(b) of the Exchange Act and Rule 10b-5.

8 D. Loss Causation

9 "Loss causation is the causal connection between the
10 [defendant's] material misrepresentation and the [plaintiff's]
11 loss." Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005).
12 "The complaint must allege that the practices that the plaintiff
13 contends are fraudulent were revealed to the market and caused the
14 resulting losses." Metzler Investment v. Corinthian Colleges, 540
15 F.3d 1049, 1063 (9th Cir. 2008). The complaint must allege that
16 the company's "share price fell significantly after the truth
17 became known." Dura Pharms, 544 U.S. at 347. "So long as the
18 complaint alleges facts that, if taken as true, plausibly establish
19 loss causation, a Rule 12(b)(6) dismissal is inappropriate." In re
20 Gilead Sciences Securities Litig., 536 F.3d 1049, 1057 (9th Cir.
21 2008). The loss causation element "'simply calls for enough facts
22 to raise a reasonable expectation that discovery will reveal
23 evidence of' loss causation." Id. (quoting Bell Atl., 550 U.S. at
24 556).

25 All of Defendants' statements that allegedly reveal the
26 "truth" of the fraud Defendants committed upon the market disclose
27 negative news about Rackable's financial condition, its future
28 prospects or the competition in the computer server industry in

1 general. However, these statements do not reveal the necessary
2 causal link between the alleged fraud and the drop in Rackable's
3 stock price. Instead, they rely on a correlation between
4 Rackable's announcement of financial results and a decrease in
5 stock price. Such allegations do not plead loss causation: "So
6 long as there is a drop in a stock's price, a plaintiff will always
7 be able to contend that the market 'understood' a defendant's
8 statement precipitating a loss as a coded message revealing the
9 fraud. Enabling a plaintiff to proceed on such a theory would
10 effectively resurrect what Dura discredited" Metzler, 540
11 F.3d at 1064. Accordingly, Plaintiffs have not adequately plead
12 loss causation.

13 II. Section 20(a) of the Exchange Act

14 Plaintiffs allege control person liability against Defendants
15 based on Section 20(a) of the Exchange Act, which states,

16 Every person who, directly or indirectly, controls any person
17 liable under any provision of this chapter or of any rule or
18 regulation thereunder shall also be liable jointly and
19 severally with and to the same extent as such controlled
20 person to any person to whom such controlled person is liable,
21 unless the controlling person acted in good faith and did not
22 directly or indirectly induce the act or acts constituting the
23 violation or cause of action.

24 15 U.S.C. § 78t(a).

25 To prove a prima facie case under Section 20(a), a plaintiff
26 must prove: (1) "a primary violation of federal securities law" and
27 (2) "that the defendant exercised actual power or control over the
28 primary violator." Howard v. Everex Sys., Inc., 228 F.3d 1057,
1065 (9th Cir. 2000). Because Plaintiffs failed to plead a primary
securities violation, they have also failed to plead a violation of
Section 20(a).

CONCLUSION

For the foregoing reasons, the Court grants Defendants' motion to dismiss Plaintiffs' Complaint. Docket No. 56. The dismissal is with prejudice because Plaintiffs have had a previous opportunity to amend their complaint and the Court concludes that further amendment would be futile.

IT IS SO ORDERED.

Dated: 08/27/10



CLAUDIA WILKEN
United States District Judge